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THE JAPANESE ECONOMY IN 1984

Summary

The Japanese economy roared back last year, putting in its best annual performance in over ten years and ending the doldrums that had gripped the nation since the beginning of this decade. While U.S. growth cooled noticeably throughout 1984, the Japanese economy was definitely on the upswing as most domestic growth components made steady headway. Recovery also took firmer root in other industrialized and developing countries, providing a more hospitable environment for continued growth.

The most spectacular and troublesome aspect of Japan's 1984 growth was the role played by international trade. Surging Japanese exports and rebounding imports, combined with monetary system reforms that opened the floodgates to Japanese investment abroad, contributed significantly to global economic recovery. This development was not without criticism, however, as Japan's trade surpluses with its partners ballooned. The government remained committed to spurring domestic growth, but was fettered by fiscal deficit policies. The challenge for policymakers was to find alternatives to traditional Keynesian prescriptions for sustaining a domestic rebound.

Gross National Product Performance

According to the Economic Planning Agency (EPA), Japan's total output of final goods and services rose an impressive 5.8 percent in inflation-adjusted terms in 1984 (see Table 1). This reversed the trend in the rate of real gross

national product (GNP) growth that began in 1980, when growth slowed 0.4 percentage point to 4.8 percent, and lasted until 1983, when GNP grew just 3.4 percent. The sharp turnaround surprised everyone; both the EPA and the Organization for Economic Cooperation and Development (OECD) predicted 4 percent growth at 1984's outset. As the year progressed, the economy was performing so well that EPA raised its forecasts for the fiscal year in late September. Even so, the economy surpassed expectations.

The good news about overall growth masked the strengths and weaknesses of the rebound. EPA had hoped for real growth of 4.1 percent in personal consumption, 5.2 percent in residential construction and 5.1 percent in nonresidential fixed investment. The economy's actual performance was quite different, coming in well under the estimates for the first two components and rising beyond the forecast for the third category.

EPA's estimates for the external sector were also off by a significant margin. The initial prediction of a $23 billion current-account surplus and a $34 billion trade surplus were extremely conservative in retrospect. For the second year in a row, Japan set records in both accounts: 1984's trade surplus totaled a hefty $44 billion, which produced a current-account surplus of $35 billion. As a consequence, the economy remained highly dependent on foreign trade (see Figure 1), and Japanese policymakers fretted, even more than the

Figure 1: Growth of Gross National Product by Component by Quarter, 1982-1984

(seasonally adjusted, annualized quarterly rates of growth)

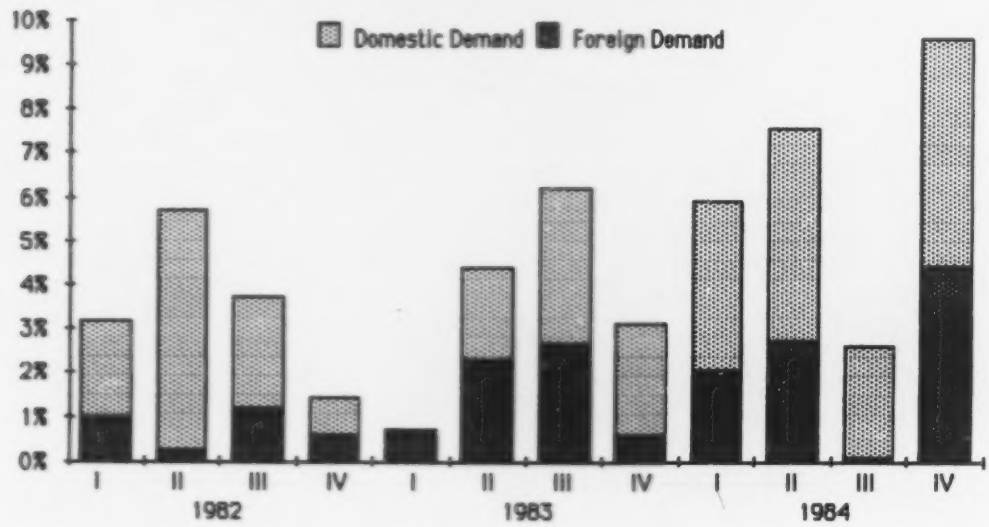

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Table 1: Japan's Real Gross National Product at Constant (1975) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	1983	1984	January-March 1984	April-June 1984	July-September 1984	October-December 1984
Gross National Product	Y210,903.5 (3.4%)	Y223,050.6 (5.8%)	Y217,927.5 (5.9%)	Y221,934.9 (7.6%)	Y223,366.6 (2.6%)	Y228,540.9 (9.6%)
Personal Consumption Spending	110,702.4 (3.4%)	113,708.4 (2.7%)	112,899.1 (3.7%)	113,323.8 (1.5%)	114,054.3 (2.6%)	114,354.5 (1.1%)
Private Residential Construction	10,060.0 (-5.9%)	9,982.6 (-0.8%)	9,958.3 (-6.0%)	9,826.1 (-5.4%)	9,965.3 (5.8%)	10,198.7 (9.7%)
Private Fixed Nonresidential Investment	36,366.0 (3.4%)	40,392.7 (11.1%)	38,716.6 (12.0%)	39,678.7 (10.3%)	40,658.3 (10.2%)	42,343.3 (17.6%)
Change in Business Inventories	869.4 (-52.8%)	1,190.3 (36.9%)	834.6 (-276.1%)	1,155.2 (267.0%)	1,485.9 (173.7%)	1,282.2 (-80.4%)
Government Current Expenditures	19,728.6 (2.9%)	20,160.8 (2.2%)	19,991.6 (3.6%)	20,152.2 (3.3%)	20,270.8 (2.4%)	20,235.4 (-0.7%)
Government Fixed Investment	18,359.9 (-0.6%)	18,091.3 (-1.5%)	17,632.7 (-11.5%)	18,368.9 (17.8%)	18,504.7 (3.0%)	17,964.1 (-12.6%)
Change in Government Inventories	-320.2 (*)	92.7 (*)	-74.5 (*)	6.4 (*)	488.0 (*)	-47.5 (*)
Net External Sector	15,137.4 (26.6%)	19,431.8 (28.4%)	17,969.5 (47.9%)	19,423.6 (36.5%)	17,939.3 (-37.4%)	22,210.2 (135.0%)
Exports of Goods and Services and Factor Income Received	42,353.5 (4.7%)	50,037.6 (18.1%)	47,208.2 (19.6%)	49,462.1 (20.5%)	50,166.9 (5.8%)	53,141.9 (25.9%)
Imports of Goods and Services and Factor Income Paid	27,216.1 (-4.5%)	30,605.7 (12.5%)	29,238.7 (5.6%)	30,038.5 (11.4%)	32,227.6 (32.5%)	30,931.7 (-17.8%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

previous year, over the consequences of the country's trade performance as exports outgrew imports.

Quarterly growth, except for a third-quarter dip caused by a surge in imports, accelerated throughout the year, reaching close to a 10 percent annual rate in the fourth quarter. Government outlays had only a minor impact, as declining current expenditures failed to slow the economy. Balancing the weak performance turned in by the government and private consumer spending, bullish private investment, resurgent residential construction in 1984's second half, and a strong net external sector stoked the economic fires.

Personal Consumption - Consumer spending remained a dark spot on the economy's shining record. Its growth rate dropped one-fifth from 1983, averaging less than half the overall rate of growth. On a quarterly basis, consumer demand started off at a healthly 3.7 percent annualized rate, but fell to 1.1 percent by the final three months of the year. Although this component still accounted for over half of GNP, its share fell from 52 percent in 1983 to 51 percent in 1984.

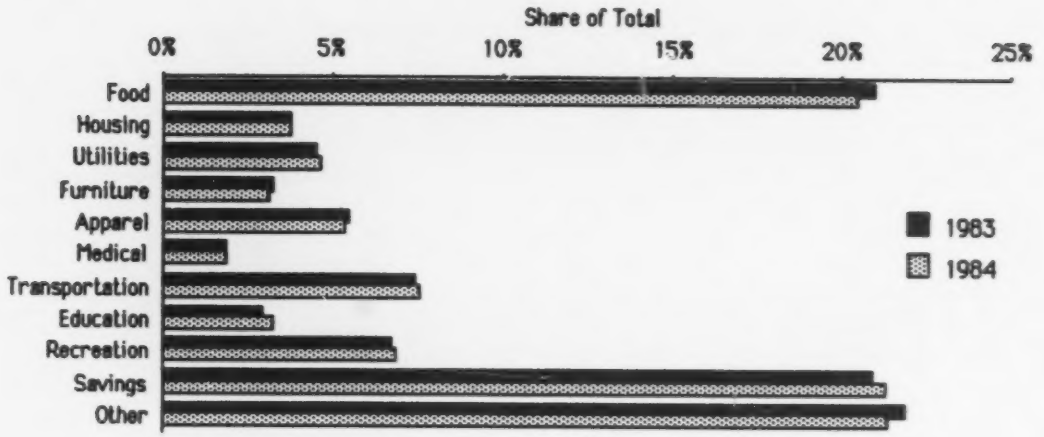
Government analysts were particulary concerned that this weak showing materialized despite a host of positive factors: an income-tax cut; spring wage hikes averaging 4.5 percent and an identical increase in biannual bonuses; an 8.6 percent jump in the incomes of second wage earners; an improvement in overtime hours of 5.3 percent; and a rise in disposable income of 4.4 percent. Factoring in inflation for 1984 (2.2 percent), disposable income rose 2.2 percent, far above the 0.7 percent real gain in 1983.

Higher food bills ate up 10.3 percent of the Y15,240 ($61 at current exchange rates) nominal increase in average monthly disposable income per household; transportation costs followed with a 9.9 percent share; education took 8.6 percent; utility bills, 8.3 percent; recreation, 7.7 percent; housing, 4.1 percent; household durables, 3 percent; medical care, 2.9 percent; apparel, 2.1 percent; and miscellaneous expenditures, 12.1 percent. Savings continued to take the lion's share of the increase, 31 percent, although this represented a decline from the previous year's 34.9 percent.

Nevertheless, savings as a percent of disposable income rose to 21.3 percent from 1983's 20.9 percent. The portion of income going to basic needs, including utilities (4.7 percent), transportation (7.6 percent) and education (3.3 percent), similarly turned up. The share devoted to discretionary expenses fell, with purchases of household goods declining to 3.2 percent and clothing to 5.4 percent, although recreation rose by a slight 0.1 percentage point to 6.9 percent (see Figure 2). Despite improved conditions, it is clear that Japanese consumers remained as thrifty as ever, posing a major hurdle to increased sales of domestic or foreign consumer goods.

Private Residential Construction - After putting in a depressing performance in 1983 for the fifth year in a row, the housing industry staged a strong comeback in the second half of 1984 that almost erased the first half's contraction. The slim 0.8 percent real decline on a GNP basis for 1984 hid a jump in housing starts of 50,485 units, a 4.4 percent increase over 1983.

Figure 2: Distribution of Disposable Income, 1983-1984



The trend toward smaller units continued as the floor area of new housing starts rose just 0.8 percent. Contractor prices, however, rose a healthy 4.8 percent. Rental units increased their share of new construction for the second year, taking 39.1 percent versus 34.7 percent in 1983 -- just slightly less than the 39.6 percent share of owner-occupied units. This rapid expansion of rental construction was largely due to consumer reluctance to shoulder mortgages in what they still perceived as uncertain times.

This attitude was amplified by the government's continued austere fiscal policies. The publicly funded Housing Loan Corp. (HLC), which provided approximately 34 percent of the total supply of housing funds in 1984, recorded a reduction in the value of new loans of 1.4 percent and a 9.7 percent drop in the number of new cases. Although increased lending by banks, savings and loans, and mortgage companies wiped out the HLC's contraction (a Y286.5 billion gain versus a Y43.4 billion decline), all lenders experienced a reduction in the number of new loans because of the absence of middle-class buyers. Psychological factors are clearly restraining the housing market, a situation the government could -- but may be unwilling to -- alter.

Private Nonresidential Investment - In terms of investment in plant and equipment, 1984 represented a return to the high growth era of the 1960s, with an 11.1 percent real increase. This was nearly quadruple 1983's 3.4 percent level and reflects consistent quarterly performances of 10 percent-plus. After hitting a plateau in the middle of the year, investment turned sharply upward in the final quarter of 1984, relieving concerns about a possible economic slowdown.

A sectoral analysis of investment activity reveals particular strength in electronics, nonelectric machinery, nonferrous metals, ceramics and motor vehicles (see Table 2). Operating rates provide the underlying rationale for

Table 2: Capital Investment by Sector, FY 1983-FY 1984

(in billions of yen; percentage change)

	FY 1983 (Actual)		FY 1984 (Estimated)	
All Industries	Y19,043.8	-1.0%	Y21,090.4	10.7%
All Manufacturing	8,151.4	-2.9	9,421.8	15.6
Foods	563.5	5.3	516.5	-8.3
Textiles	149.1	-14.8	182.8	22.6
Wood Products	30.0	21.1	40.4	34.5
Paper and Pulp	186.2	-3.9	312.2	67.7
Chemicals	1,195.8	1.3	1,259.5	5.3
Oil and Coal	267.9	-5.2	281.6	5.1
Rubber and Leather	114.9	21.2	147.4	28.3
Ceramics	302.3	-6.1	395.1	30.7
Steel	960.9	-16.0	845.9	-12.0
Nonferrous Metals	212.5	-14.5	260.5	22.6
Metal Products	253.4	20.7	275.0	8.5
Nonelectric Machinery	409.3	-10.6	506.3	23.7
Electric Machinery	1,692.0	8.8	2,387.6	41.1
Transportation Machinery	1,128.7	-14.2	1,287.0	14.0
Precision Machinery	226.8	4.7	230.7	1.7
Other Manufacturing	458.2	4.4	493.5	7.7
All Non-manufacturing	10,892.5	0.5	11,668.6	7.1
Agriculture	36.1	73.7	19.6	-45.7
Mining	219.8	-2.3	197.4	-10.2
Construction	324.0	-12.4	267.3	-17.5
Wholesaling and Retailing	1,045.4	-16.8	1,071.1	2.5
Wholesaling	513.2	-23.9	469.9	-8.4
Large Retailers	279.1	-12.8	275.7	-1.2
Other Retailers	253.1	-3.5	325.4	28.6
Finance and Insurance	507.6	12.2	585.5	15.3
Real Estate	846.1	3.2	942.1	11.4
Transportation and Communications	1,364.4	-12.5	1,329.7	-2.5
Private Railways	283.9	-11.7	309.0	8.8
Ground Transportation	317.8	12.2	290.5	-8.6
Shipping	370.3	-39.0	311.2	-16.0
Other	392.4	13.1	419.1	6.8
Electric Power	3,401.7	0.4	3,397.0	-0.1
Gas	282.4	-12.0	282.8	0.1
Services	2,865.0	18.3	3,576.1	24.8

Source: Economic Planning Agency

the prominence of the first three sectors as output boomed, pushing up capacity utilization in the manufacturing sector by 8.4 percent. The large increases in other sectors were devoted to modernization, for example in the ceramics and motor vehicle industries, or rationalization, which characterized the oil industry. These statistics underscored the importance of foreign trade to Japan's economy and the softness of domestic demand.

Change in Inventories - The economic upturn was clearly reflected in this erratic component of gross national product, which rebounded from a three-year decline, rising 36.9 percent. The strength of the rebound in production and shipments was evident from the large quarterly changes. The same industries that accounted for the strength of capital investment also contributed to the 11.1 percent rise in manufacturing production. Although inventories were up significantly, there were few signs of a slowdown at the end of the year.

Public Sector - Because of the government's strong desire to cut the deficit, public spending provided little stimulus in 1984, as both current expenditures and fixed investment came in under 1983's levels. The Nakasone government continued to spend the majority of its outlays in the first half of the fiscal year (April to September), a policy that has not been very successful at promoting expansion for two reasons. First, supplementary budgets, which might be expected to boost spending at the end of the fiscal year, have been held down in the name of austerity. And second, since front-loading is now a standard practice, the market does not respond to the seemingly robust figures of the first two fiscal quarters, nullifying any psychological impact from government spending.

The growth of current expenditures slid throughout the year and would have been even lower in the last quarter of fiscal 1983 (January-March 1984) had it not been for accelerated emergency relief outlays and a few other government support programs. Public works expenditures showed a sharp 1.5 percent drop in real terms, nearly triple 1983's rate of contraction. Mr. Nakasone appeared to be keeping his pledge to get government expenditures under control, but as a consequence, the public sector continued to play a smaller role in generating economic growth.

External Sector - Because the net external component is the difference between exports and imports, its erratic behavior in 1984 was not unusual. Even in light of the global recovery, 28.4 percent real growth was surprisingly strong. While this figure was 26.6 percent in 1983, it resulted from a modest gain in exports and an import decline. The 1984 figure had a more robust foundation: an 18.1 percent export growth and a 12.5 percent import gain. All this activity kept the share of overall GNP growth directly attributable to foreign trade at a high level in 1984 -- 36 percent, although this was down sharply from 1983's 50 percent contribution.

Unquenchable overseas demand for Japanese consumer goods, business equipment and automobiles kept exports at a high level throughout the year. In turn, the increase in demand for industrial inputs coupled with stable commodity prices drove up imports. The third quarter was somewhat anomalous because of an import surge/export slump. Japanese observers attributed the figures to an acceleration of oil purchases in advance of a new oil consumption

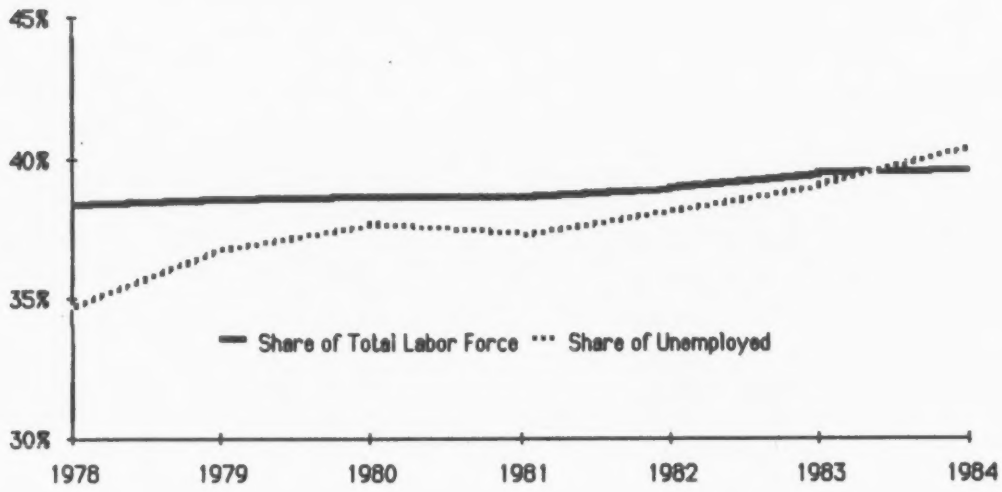
tax. According to official trade statistics, however, quarterly oil imports barely changed over the last three quarters of the year. In any case, 1984 represented a return to export-led growth reminiscent of earlier decades -- a cause for concern among policymakers.

Labor and Inflation

Japan's employment picture in 1984 was bright in comparison to other industrialized countries, but bleak by historical standards. Although a net 380,000 new jobs were created, unemployment actually rose over the previous year, hitting 2.7 percent, the highest level since such statistics were first compiled 32 years ago. On a monthly basis, a downward trend was visible: after peaking at 3.1 percent in March, the rate fell steadily to 2.4 percent at year's end.

One of the more interesting aspects of the labor pool was the increasing role of women, who accounted for 57 percent of 1984's new workers and 63 percent of 1983's labor market entrants. Women took 52 percent of the new jobs in 1984, down from the 67 percent level of the previous year. On the other hand, women represented a disproportionate share of the unemployed, accounting for 80 percent of the total. Since the labor force participation rate actually fell 0.4 percentage point to 63.4 percent in 1984, it appeared that women were acting as buffers in Japan's labor market (see Figure 3).

Figure 3: The Role of Women in Japan's Labor Force, 1978-1984



Japanese workers across the board scored impressive productivity gains in 1984. In manufacturing and mining, output per worker jumped 9.9 percent, but as was the case with other measures of economic activity, the average was boosted by a few star performers: electric machinery, 20 percent; precision

equipment, 16.6 percent; steel, 12.1 percent; and nonelectric machinery, 11 percent. Gains were scored by workers in nearly all industries, however.

Inflation was kept under control in 1984, in large part due to productivity gains, moderate wage increases and stable world prices for basic industrial materials and foodstuffs. Wholesale prices fell for the second year, slipping 0.3 percent as declining prices for raw materials (off 2.5 percent) and intermediate goods (down 0.5 percent) more than offset higher prices for final goods (up 0.5 percent), especially consumer goods. Stable or declining import prices also helped keep wholesale prices in line, particularly the 4.1 percent drop for raw materials and fuels.

Consumer prices rose 2.2 percent, only slightly faster than 1983's 1.9 percent increase. Higher prices for food (up 2.8 percent), the single largest component in the index, were the main culprit, but the rising cost of clothing (up 2.6 percent), recreation (up 2 percent) and transportation (up 0.9 percent) also contributed.

Despite the ups and downs of the yen, export prices rose by a slim 0.6 percent in 1984 after tumbling 6 percent the year before. Voluntary restraints on automobiles again let Japanese manufacturers raise prices, pushing overall transport equipment prices up 2.2 percent. Prices for other products remained generally stable, with the exception of metals and metal products, which rose 2.3 percent.

Monetary Policy

At first glance, it would appear that Japanese monetary policy authorities faced no difficult decisions in 1984 because of stable prices and surging domestic investment. The usual indicators of the direction of monetary policy -- money supply growth and interest rates -- present a picture of calm. In reality, 1984 was a very busy year, as Finance Ministry (MOF) and Bank of Japan (BOJ) officials focused on the basic structure of the country's monetary system and its links to international financial markets.

Money supply growth in 1984 was consistent with the growth of the economy. All categories of money showed increases. M1 plus certificates of deposit (CDs) was 8.5 percent higher in December than in the year-earlier month, itself 6.4 percent above the December 1982 mark, and the broader measure of M2 plus CDs grew 7.8 percent between December 1983 and December 1984, or slightly faster than 1983's 7.3 percent rate.

Interest rates drifted downward despite no change in the Bank of Japan's official discount rate (which is analogous to the Federal Reserve's discount rate). While the BOJ's official discount rate remained steady at 5 percent, the prime rate on long-term loans dropped by 0.3 percentage point twice in 1984, hitting 7.9 percent in late March and 7.6 percent at the end of October. Government pressure on the long-term banks to lower their rates was clearly intended to push other rates down and keep the recovery going. The interest rate on 10-year government bonds on the resale market drifted up and down, but ended the year almost a full point lower at 6.4 percent. Other market-determined rates, however, resisted downward pressure: call rates on the Tokyo market drifted from 6 percent in January to 5.7 percent in May and then moved

up to 6.4 percent by December; and bond repurchase yields (gensaki) hovered around 6.3 percent throughout the year.

The yen-dollar exchange rate has been a recurring topic at U.S.-Japan negotiations -- talks that culminated in 1984 with the release of the report of the Ad Hoc Group on Yen/Dollar Exchange Rate, Financial and Capital Issues. The accord committed Japan to fundamental changes in its monetary system, opening it to market forces and integrating it with the international financial system. The accord's provisions will be implemented over several years; Tokyo agreed to institute the following changes in 1984.

Effective April 1, 1984:

- The real-demand rule for forward exchange-market transactions was dropped, allowing speculative dealings.
- The minimum allowable denomination for certificates of deposit was cut to Y300 million ($1.2 million) and the maximum allowable amount of issues was raised to 75 percent of a bank's net worth.
- The prohibition on the sale of foreign certificates of deposit and commercial paper on Japanese markets was abolished.

Effective June 1, 1984:

- The "designated company" system restricting foreign investment in certain companies was abolished.
- The government was authorized to issue foreign-currency-denominated government bonds.
- Guidance over lending abroad by Japanese banks was ended, including restrictions on the overall amount of lending, country limits, and restrictions on participation in syndicated lending.
- The limits on currency swaps by foreign and domestic banks were eliminated.
- The prohibition on Euroyen loans to Japanese residents was lifted.
- The guidelines for Euroyen bond issues by Japanese corporations was eased, expanding the eligible issuers to about 100.

Effective December 1, 1984:

- Non-Japanese corporations, local and central governments, government corporations and international financial institutions were granted permission to issue Euroyen bonds with the same qualifications for issuers as in the samurai bond market, with no restriction on the size of issues. (Samurai bonds are yen-denominated bonds issued by foreign governments or international organizations.)
- Restrictions limiting lead underwriters on Euroyen bond issues to Japanese financial institutions were eliminated.

From the Japanese viewpoint, the changes improve the efficiency and flexibility of Japanese capital markets and the competitiveness of corporate and financial institutions. Consumers also benefit from greater reliance on free-market mechanisms by receiving improved services and higher returns. From the American side, the agreement was designed to increase international use of the yen, increasing demand and pushing the currency up relative to the dollar. A higher yen and freer interest rates were expected to reduce the international competitiveness of Japanese firms. It was thought, moreover, that liberalized capital markets would give U.S. banks and financial institutions a chance to gain a larger share of lucrative Japanese business.

Unfortunately, the strength of the American economy and high U.S. interest rates proved irresistible to foreign investors, including Japan's. After rising to Y226=$1.00 by April, the yen fell back to a plateau of Y245=$1.00 until late in the year when it fell precipitously, hitting Y251=$1.00 by December (see Figure 4). Still, Japanese corporations and foreign financial institutions took advantage of the new rules, and financial flows in and out of Japan skyrocketed. The problem was that the net flow was mostly out of the country, putting downward pressure on the yen. U.S. disappointment with the short-term effects of the agreement put pressure on Tokyo to accelerate deregulation, but Japanese authorities resisted, arguing that too rapid a change would disrupt the economy.

Figure 4: Yen-Dollar Exchange Rate, January, 1983-January, 1985

(yen per dollar, monthly average)

Whatever the pace of change, liberalization presented Japanese policymakers with a host of new problems, not only concerning implementation but also the basic conduct of monetary policy. Nonetheless, the yen-dollar accord represented an important step toward Japan's integration into the global economy.

Fiscal Policy

Fiscal stimulus remained under tight control in the FY 1984 (April 1984-March 1985) general account budget, which rose a tiny 0.5 percent over FY 1983's total. The success of the Finance Ministry's campaign to hold the line on spending began to impact on Diet members whose districts rely on public works projects. Nevertheless, the importance of curbing the current and accumulated deficits remained a top political priority, even if it was not urgent in economic terms.

The Y50.6 trillion ($225 billion) general account budget contained a Y12.7 trillion deficit despite a projected 7 percent increase in overall tax revenues from new taxes on luxury goods, higher automobile taxes and hikes in corporate taxes. Underscoring the debt problem was the 12 percent increase in debt service costs, the second-largest item after social security. Other discretionary items were cut, including public works and agricultural price supports, leading to a 12 percent decline in total discretionary spending. The drop would have been greater had it not been for increased outlays for defense (up 6.5 percent), foreign aid (up 7.9 percent), science and technology (rising 3.2 percent) and energy programs (up 0.9 percent).

Alterations of the tax codes were minor: industry got no new significant breaks. On the contrary, a temporary tax was levied on corporations and some other tax provisions were reduced to bring in more revenue. Business organizations began a campaign to reduce their tax burden, arguing that the Japanese government levied the highest effective tax burden of any industrialized nation. As the public's unhappiness with the tax system grew and the fiscal deficit expanded, politicians began preparing the country for an overhaul of the entire tax structure -- a process that is likely to take several years.

In addition, the Fiscal Investment and Loan Program budget, a second budget funded by deposits in the postal savings system, government trust funds and special taxes used for public works projects, exhibited negligible growth. Most programs were held constant or cut, putting political pressure on representatives from rural areas.

The FY 1984 supplementary budget was approved December 24, 1984, contributing an additional Y886 billion, or 2 percent, to spending. The additional funds were spent on disaster relief projects, a pay raise for civil servants, housing subsidies and various obligatory transfers.

As noted earlier, the impact of fiscal policy was marginally positive during 1984 given the miniscule rise in overall outlays and imposition of new taxes. Although the country's continued surplus of savings over investment narrowed in 1984, one could argue that there was still a large role for stimulative fiscal policy without adverse consequences. The political atmosphere for such a course, however, remained hostile. The disappointing fact was that the government failed to come up with concrete proposals to spur the growth of private domestic demand, leaving Japan highly dependent on overseas trade and susceptible to foreign pressure.

FY 1985 Budget Process - A continuation of this fiscal paralysis is likely given the Finance Ministry's guidelines for the fiscal 1985 budget and the medium-term budget outlook. That forecast painted a dark picture of ballooning debt service costs through 1988 even if current deficits were capped. The budget proposal for the current fiscal year, submitted by MOF at the end of 1984, showed no increase in discretionary spending, but a 3.7 percent increase in overall outlays because of growing interest payments on the national debt. It is clear that the government is emphasizing a crisis atmosphere to force the nation to a consensus on painful budget cuts and fiscal reforms. While this may be good politics, it does not spell good news for measures to support economic growth.

Administrative Reform - The idea that smaller government is better government bore fruit in 1984 when the Diet approved legislation to de-nationalize the domestic telecommunications and tobacco products markets. These steps represented significant victories for Mr. Nakasone and Japan's trading partners since they promised greater access to two of the country's most lucrative markets. The gains were not painless, however, as Washington and Tokyo debated the reforms under heavy pressure from domestic interests. Administrative reform has become strongly entrenched in public and private circles, promising further important changes in coming years.

Conclusion

The world's second-largest economy made significant strides in 1984, taking advantage of strong foreign demand, steady input prices and resurgent capital investment. The implications of this strong performance were that the country had completed its adjustment to the oil crises and was entering a new period of high growth. While Japan certainly seems to have adapted to higher energy prices and shifting world trade patterns, this conclusion may be a bit premature in light of the country's continued dependence on foreign trade. The movement toward knowledge-intensive domestic industries has picked up speed and will get a large boost from the opening of the domestic telecommunications market. The economy still faces several fundamental hurdles, however. A means of spurring domestic demand without expanded government outlays must be found, and the consequences of monetary liberalization must be dealt with. Despite these obstacles, the economy seems poised for solid growth over the medium term.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.